

USWC attended each public hearing with Company representatives from various operational areas who met after the hearings with individuals expressing service complaints.

PART THREE:

SERVICE QUALITY ISSUES

During the Commission's hearings for public testimony, conducted in seven cities around the State, customers repeated three themes time after time: the inability to get timely installation of service -- or in some instances, any service at all; delays experienced in getting service restored following an outage; and opposition to the magnitude of the proposed rate increase. The Commission scheduled a special hearing session to address customer service quality and sought information from top Company executives responsible for service.

This order segment begins with an overview of service quality problems in this state. It is followed by a discussion of the parties' recommendations on customer service issues and the Commission's decision.

I. Service Quality Problems

In January 1993, the Commission adopted rules establishing a minimum level of service quality to be observed by telecommunications companies providing service within this state⁸. These service quality standards and requisite service quality performance reports, when coupled with other service requirements of Chapter 480-120 WAC,⁹ are designed to ensure all consumers of telecommunications services in this state timely installation and reasonable continuity of service, uniformity in the quality of service furnished, and safety of persons and property.

The Commission Staff became aware of a significant and disturbing trend in service quality degradation for the Company beginning in 1991. The number of informal service complaints reported to the Commission increased dramatically in the years 1992-1994, and appear to be escalating to an all-time high in 1995. These complaints largely address inability to obtain service in a timely manner, and undue delay in restoring service outages.

⁸ On January 27, 1993, in Docket No. UT-921192, the Commission adopted WAC 480-120-500, -505, -510, -515, -520, -525, -530, -535, the rules were filed with the Code Reviser on February 26, 1993, and became effective on March 29, 1993.

⁹ Included among the more pertinent rules in this regard are WAC 480-120-041, Availability of information; WAC 480-120-051, Availability of service--Application for and installation of service; and WAC 480-120-086, Adequacy of service.

The Commission Staff during this timeframe, principally through the Commission's Consumer Affairs Section, diligently pursued not only resolution of individual complaints but also sought to gain the attention and support through ever-escalating levels of USWC's senior management in an attempt to reverse the trend. The Company constantly reassured Commission Staff, in meetings and in written communications, not only of its commitment to service quality, but of its intention to resolve permanently its service quality problems. Ex. 102-T, pp. 17-19; Ex. 107, 108, 109. The Company has been delinquent on both counts.

Commission Staff believes its attempts over the past several years to negotiate improvements in the Company's service quality informally and cooperatively have failed. It argues that the Commission must therefore take affirmative steps to address service quality issues, relieve the burdens on consumers engendered by poor service, and stimulate responses by the Company which will permanently resolve service quality problems in this state.

The Company's senior management has consistently pointed to unanticipated and unforecasted access line growth for its service quality problems. Ex. 107, 108. However, the testimony in this proceeding paints a picture of causes deeply-rooted in USWC's re-engineering and restructuring efforts aimed at reducing costs (Ex. 102-T, pp. 16-17), and reduced investment in Washington State infrastructure improvements (Ex. 101-T, p. 13, 11. 16-20).

USWC has undertaken simultaneously a massive re-engineering and restructuring program to revamp and consolidate operations and reduce costs. The re-engineering effort involves the design and implementation of new computer-aided systems and programs, replacing paper and manual handling of information, to increase efficiency and create opportunities to enhance productivity and expand the number of functions performable by one employee during a single customer contact.

This re-engineering effort included the consolidation of service centers. This consolidation resulted in significant reductions in this state of personnel familiar with the intrastate network and facilities -- a 30% reduction in engineering staff in Washington in just two years (TR 1007). The Company experienced significant errors when paper records containing faulty inventory of facilities were manually posted to electronic databases in the new systems; Washington State records at the time of entry into the new databases were apparently poorer than average, which the Company hopes to resolve in mid-to-late-1996. (TR 1007). Finally, these new computerized systems, while a significant technological leap over former manual systems, were intended to be a transitional step toward an even more automated engineering tool. Unfortunately, this more sophisticated tool was to come on-line in third quarter 1995, but its complexity was so overwhelming the Company now projects an on-line date no earlier than sometime in 1997. (TR 1029-1030).

The Commission believes the Company's restructuring and re-engineering efforts may well be appropriate in an emerging competitive environment. USWC has made tough

decisions and moved decisively to implement those decisions. The transition has been difficult for all concerned -- the dislocated employees, the management struggling to bring new systems and programs on-line with little lead time, the employees attempting to master the re-engineered systems, at times with incorrect or inadequate information available to them, and in some instances without sufficient training, and the customers experiencing newly re-trained employees who with their inability to use the new systems successfully are as frustrated as the customers who are getting no satisfactory resolution of their problems.

USWC's Washington Vice President Dennis Okamoto admits that the Company's re-engineering effort has contributed to service quality problems. (TR 717-718). He also acknowledges that its employees are still on the "learning curve" in terms of mastering the newly re-engineered systems, and that process may take up to another year to complete. (TR 714-716).

The Commission expects, as Company witnesses represented, that once the "bugs" are eliminated, all systems are available, installed, operational, and in the hands of a qualified and trained work force, USWC will provide and its customers will experience the level of service to which they are entitled. The improvement however has yet to materialize.

The fact remains that USWC has failed to meet its minimum service obligations, failed in dramatic and painful ways for all classes of its customers, and failed increasingly, year after year.

USWC witness Dennis Okamoto testified that a hostile capital structure and capital recovery environment in this state has led the Company to reduce its Washington investment, and has led in turn to shortages of necessary facilities.¹⁰ The record confirms that the Company's capital investment has fallen in Washington and continues to lag 1992 levels. The record shows that the Company earned a return of up to or exceeding 11% during the five years of its alternative form of regulation (AFOR) and kept over \$77 million in excess earnings. The record also shows that the Company was significantly reducing its capital investment in this state during those same years.

Commission Staff notes the Company's Form M Annual Report to shows that new investment per year in Washington declined from \$354 million in 1992 to \$268 million in 1994, a decline of \$86 million. Ex. 125-T, pp. 9-10. USWC witness Okamoto testified that the Company likely will have spent over \$330 million on capital expenditures in Washington in 1995. TR 550. This level still represents a decline over 1992 investment, before accounting for inflation. The

¹⁰ Mr. Okamoto, in response to questions from AT&T, acknowledged that internal competition for funds for capital investment purposes is keen, and that the payment of 100% of its dividend to the parent company, U S WEST, Inc., has resulted in substantial investment overseas and domestically outside its service territory. Mr. Okamoto asserted that "[t]he shareholders demand that managers of the business invest the capital dollars appropriately and where they can get the best returns[.]" (TR 729-732)

same Form M shows that depreciation expense has increased from \$226 million in 1992 to \$301 million in 1994, a \$75 million increase. Ex. 125-T, p. 9. To the date of filing of its testimony in this case, Staff notes the Commission has authorized in 1995 additional adjustments to the normal depreciation reserve accruals of more than \$30 million.

II. Held Orders and Service Interruptions

A. Complaint Levels

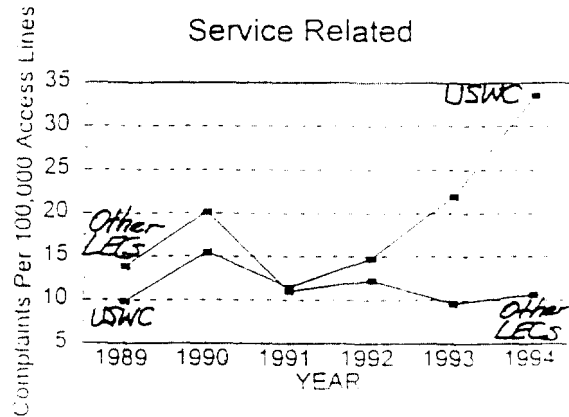
Commission Staff presented a study quantifying the number of informal service complaints being filed against USWC, and the number of resulting Commission rule violations from held order and service interruption complaints.

When compared to other local exchange companies (LECs) in the 1989-1994 time period, USWC's growth in access lines was comparable to other LECs only in 1991, and was less than other LECs for the remaining years in the study period. In all years but 1989 and 1990, USWC service complaints and rule violations per 100,000 access lines far exceeded those of other LECs. The Company did not substantiate its representations that growth is the root cause of its service quality problems. Ex. 103, 104, 105. Likewise, when compared only to itself in the 1989-1994 time period, USWC service-related complaints and rule violations show dramatic growth, indicating not only service quality deterioration, but continuing deterioration of unprecedented scale. Ex. 106.

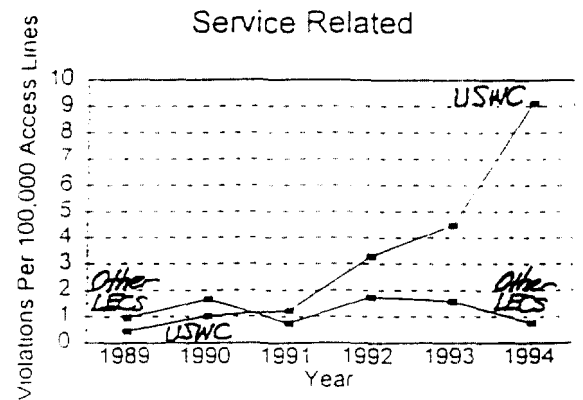
Several exhibits illustrating trends in service quality identified in the Commission Staff study are reproduced in this order.¹¹

In January 1995, Mr. Okamoto committed to corrective actions aimed at eliminating held orders and service interruption violations by April 1, 1995, reducing total 1995 complaints by 30% over 1994 levels, and reducing total 1995 rule violations by 75% in 1995. The Company showed some improvement between January and April 1995, but in May through August 1995, both total numbers of complaints and rule violations increased substantially. Ex. 110, 111, 112, 113. As of August 1995, held order and service interruption complaints were at their highest level and were continuing to increase rather than decline. Ex. 102-T, p. 21.

¹¹ Four of the exhibits are labelled "Rule Violations." However, this assessment is based upon Staff's analysis of recorded complaints, and does not represent a determination by the Commission after notice and an opportunity for hearing, that USWC has violated the Commission's rules.

COMPLAINTS 1989 - 1994

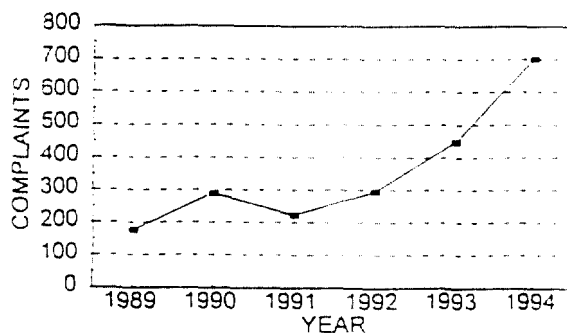
EX. 104

Rule Violations 1989 - 1994

EX. 105

US WEST COMPLAINTS

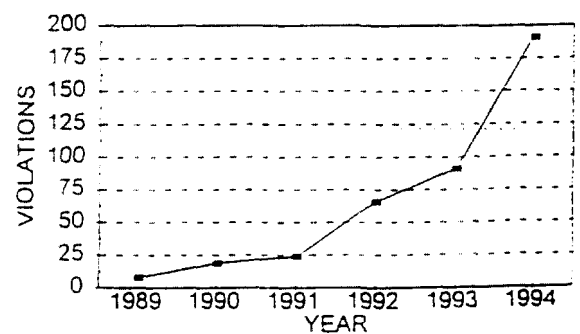
SERVICE RELATED



EX. 106, P. 1 of 2

US WEST Rule Violations

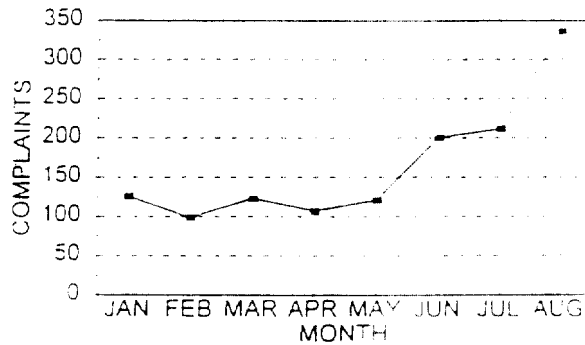
1989 - 1994 Service Related



EX. 106, P. 2 of 2

US WEST Complaints 1995

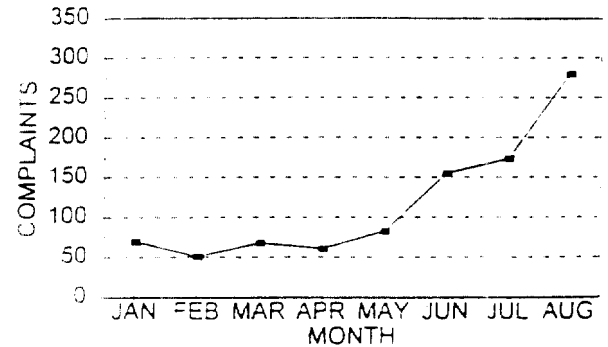
Total Complaints



EX. 111

US WEST Complaints 1995

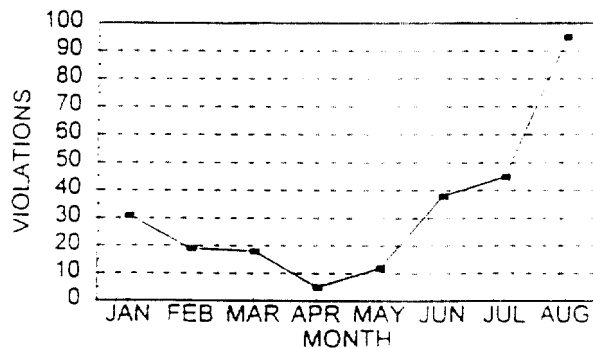
Service Related



EX. 112

US WEST Rule Violations

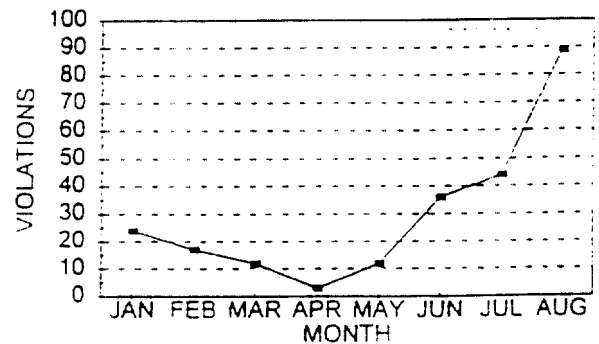
1995 Total Complaints



EX. 113

US WEST Rule Violations

1995 Service Related



EX. 110

B. Rule Violations

Service quality complaints involving held orders and service interruptions largely reflect violations of two Commission rules. WAC 480-120-051 requires that if, prior to an agreed-upon date for installation of service, it becomes apparent that service cannot be installed as agreed, a company shall promptly notify an applicant of the delay and the reasons. Commission Staff reports a significant increase in the number of informal complaints where applicants are provided in-service dates by USWC, the installation is not completed as agreed, and applicants are given no notice that the date will be missed nor an explanation why the installation was missed.

WAC 480-20-520 requires that all reported interruptions of service shall be restored within two working days, except interruptions caused by emergency situations, unavoidable catastrophes, and force majeure. Again, Commission Staff notes significant increases in the number of informal complaints regarding restoration of service in the required timeframe. Based upon customer complaints and Company responses to informal service complaints, Staff believes failure to meet installation and repair obligations is due primarily to reductions in technical and engineering work force. Ex. 102-T, p. 5

A majority of those testifying at public hearings around the state related personal experiences with poor service quality -- repeatedly delayed installation of new service, often without prior notice, and unreasonably delayed restoration of service outages. This testimony tracks the nature of the service complaints received by the Commission during the preceding four years.

C. Recommendations Addressing Service Quality Problems

A disagreement exists between the Company and Commission Staff over what constitutes a "held order" resulting in a rule violation. WAC 480-120-051(1) and (2) prescribe for all local exchange companies the explicit conditions for the installation of primary exchange access lines.¹²

¹² WAC 480-120-051 reads in part as follows:

(1) As measured on a calendar monthly basis, ninety percent of a local exchange company's applications for installation of up to five residence or business primary exchange access lines in any exchange shall be completed within five business days after the date of receipt of the applications when all tariff requirements have been met by the applicant or subscriber. In those instances where a later installation date is requested by the applicant or subscriber or where special equipment or service is involved, this time period does not apply.

(2) Ninety-nine percent of all applications for installation of primary exchange access lines in any exchange shall be completed within ninety days after the date of receipt of the applications when all tariff requirements have been met by the applicant or subscriber.

First, under its system of record-keeping, the Company reports to the Commission the monthly total of orders held at a given point in time. The Company asserts that once an order is completed the record is deleted. The information is not reported in a detail that permits Commission Staff to determine the length of time any individual order was held by the Company. Thus, Staff cannot determine, for example, that in a January 31 report of 200 held orders the Company also had 700 held orders between January 1 and January 29 that were held longer than five working days but completed prior to the reporting date. Second, it is the Company's position that "primary exchange access" involves only the first line into a premise and that additional lines are not covered by the rule, despite the rule's clear directive that "up to five residence or business primary exchange access lines in any exchange shall be completed within five business days" when all other conditions of the rule are satisfied.

Commission Staff recommends that the Commission require USWC to provide monthly service order reports which, at a minimum, include the following information by exchange by class of service:

The number of all orders for primary exchange access lines received in a given month;

The total number of orders held beyond five business days, identifying the number not requiring special equipment or service and the number requesting a later in-service date; and,

The cumulative reporting of all held orders until service is installed and in working condition.

The Commission will order the record-keeping and reporting requirements recommended by Commission Staff. These measures will provide information sufficient to permit verification of compliance with WAC 480-120-051 and afford the Commission the opportunity to pursue enforcement for violations of that rule.

Commission Staff witness Spinks recommended that the Commission order USWC to provide customers with cellular phone service when ordinary service cannot be provided within 30 days. Specifically, if customers are required to wait more than 30 days for service over Company facilities, the customer would be provided with cellular service, using a carrier of the customer's choice, at the same rate the customer would pay for the Company's service. The Company would pay the difference up to \$150 in cellular service per month.

In its response to Bench Request No. 13, filed on February 12, 1996, USWC informed the Commission that it had recently introduced a service guarantee program throughout its 14 state service area. The program includes

1. Service orders held over five business days, but less than 30 calendar days, will receive an installation credit of \$31.00; the customer will also be offered at no cost a Market Expansion Line/Remote Call Forwarding service which includes assignment of the new telephone number, a USWC calling card, and a directory listing;
2. For service orders held more than 30 calendar days, Washington customers will receive either a credit for Basic Exchange Service of \$10.75 for month or partial month the order is held, or a cellular subsidy payment of \$105.00 for the first month and \$75.00 for each additional month.

The Company indicated it would begin offering the new service guarantee program in Washington on March 5, 1996.

The Commission will order implementation of a customer service guarantee program along the lines of that voluntarily proposed by the Company, but with modifications, to be effective immediately. Specifically, the program will include the following until modified or discontinued by Commission order:

1. For service orders for up to one residential and two business primary exchange access lines in any exchange not completed within five business days: USWC will waive installation charges, and credit the basic monthly rate; provide at no cost Market Expansion Line/Remote Call Forwarding service which includes assignment of a telephone number, a USWC calling card, and a directory listing; and
2. For service orders for up to one residential and two business primary exchange access lines in any exchange not completed within 30 calendar days: USWC will offer a subsidy payment for cellular service at the rate of up to \$150.00, less the recurring monthly rate for the local exchange service, for each month or partial month the order is held (and provide a cellular telephone) or voice messaging service or paging service or remote call forwarding service at the customer's option.

III. Other Service Failures

A. Large Customers

TRACER witness Bookey recounted service problems experienced by six large USWC customers, mostly relating to provisioning of new digital facilities which he claims generally takes from three to six months, but in many instances as long as one year. These customers range from Fred Meyer Stores, which claims every retail store in USWC's service territory has had significant problems, to the University of Washington which reports major problems with 1) trouble reporting, 2) service order processing, 3) ISDN and high capacity service provisioning, and 4) engineering. As troubling as the delay itself, for many of these customers, is communicating with USWC service personnel who are described as frustrated and inexperienced, who are frequently rude, and either fail to call back or leave customers on hold for long periods.

The placement of trouble calls to USWC which used to take a few minutes now may take from 1/2-hour to days. Inexperienced customer service staff lack sufficient technical knowledge to input trouble reports properly, resulting in faulty and insufficient information in USWC's trouble ticket tracking system. When engineering staff discover inadequate or inaccurate information, trouble tickets are closed and reported as a customer problem, requiring customers to re-start the whole process with a new trouble report.

B. Internet Service Providers

The Commission held hearings in seven cities around the state, and in all but two cities the Commission heard from entrepreneurs attempting to launch or expand Internet service provisioning businesses. Their experiences with obtaining Integrated Services Digital Network (ISDN), T-1 services, and other relevant services and assistance from USWC were varied, but all were unsatisfactory. The Company informed an applicant in Port Angeles that ISDN service would not be available in the immediate future, if ever; while in Vancouver an applicant who was told facilities and services were available to serve his proposed business location was denied facilities and service for so long that his venture capital had been exhausted and he faced the prospect of bankruptcy, having never been connected to the network at the location from which USWC had guaranteed its network was capable of serving his needs.

The Commission heard similar stories of requests for ISDN and T-1 service being met with indifference and delay in each of the other cities where Internet service providers testified. The similarity of experience of such entrepreneurs in all corners of the state from Port Angeles to Yakima, from Vancouver to Seattle, and the similarity of complaints about USWC's treatment of subscribers and attitude toward this growing segment of the economy is as disturbing as the Company's held orders and rule violations.

The Company's apparent indifference and the undue delay experienced by these start-up enterprises left one Internet service provider at the Olympia public hearing to speculate whether USWC was intentionally repressing growth of new Internet service providers in anticipation of USWC's own entry into this line of business. USWC witness Okamoto, in response to a question from Commissioner Hemstad, indicated the Company would launch its Internet service in six-to-nine months, but anticipated no facilities problems with the Company's own service. (TR 755). Chairman Nelson queried Mr. Okamoto for his reaction to the public witness' speculation about motive, and was told the Company was experiencing trouble providing high capacity services to everybody, and the Internet providers have simply been caught in this service failure. (TR 770)

C. Telecommunications' Company Customers

The telecommunications company customers of USWC also presented testimony on the deteriorating quality of the Company's services. AT&T provided testimony on two standard measures of performance -- on-time delivery and circuit failure rate -- for special access, which it characterizes as the most readily quantifiable services to provide. Comparing USWC with the other six Regional Operating Companies (ROCs), the best service provisioner met installation deadlines 99-100% of the time, depending upon the discrete service, while USWC met its commitments 74-94% of the time, again depending upon the service. AT&T "footnotes" its statistics, first by noting USWC's steadily declining performance during 1995, and second by commenting that where other providers may miss a delivery date by a day or two, USWC misses by weeks, even months. In some instances, AT&T requests for service in January-February 1995 had not been completed in August when its testimony was filed.

AT&T suggests a fully competitive market is the best solution to service quality problems, arguing performance standards and service quality reporting serve only to quantify not resolve problems.

Electric Lightwave, Inc. (ELI) complained of six general problem areas with USWC service provisioning: (1) use of a single account representative, despite its growing volume and complexity of service needs; (2) slow entry, sometimes up to days or even weeks, of ELI orders into USWC's computerized service order entry systems; (3) insufficient experienced personnel to complete installations on a timely basis; (4) inaccurate or incomplete facilities database and physical installation problems; (5) service order tracking and status and update reporting; (6) inability to engage in cooperative joint testing and failure to notify of completion of installation.

ELI requests the Commission order USWC to modify its tariffs to provide service credits for all delayed service order installations

The Commission will order USWC to implement a program of service credits for all delayed service orders. We agree with ELI that, like the service guarantee program ordered above for customers of residence and business primary exchange access lines, the specialized business customers and telecommunications company customers of USWC are entitled to reasonable service order installation guarantees.

The Commission therefore will order USWC to implement the following service guarantee program for all service order installations other than primary exchange access lines, to be effective immediately, until modified or discontinued by Commission order:

1. For all mutually agreed upon installation dates for which service is not completed as ordered, or the ordering party is either not notified the service is completed within 24 hours of installation or the new date for the rescheduled installation prior to actual installation, USWC will waive all non-recurring charges for the service/s to be installed; and
2. For every three week period and partial period of up to three weeks (i.e. 1-3 weeks; 4-6 weeks; 7-9 weeks; etc.) the ordered service/s is/are delayed, USWC will waive one month's recurring monthly charge for the service/s to be installed.

IV. Revenue Requirement Adjustments

A. Lost Revenue Adjustment

Staff witness Beaton recommends an adjustment, as shown in Ex. 704, MLT-5, for held orders during the test period; the amount of this adjustment is calculated using average residential and business bills as demonstrated in Ex. 605-C. The adjustment increases test year revenue by \$510,241 and net operating by \$325,593. Ex. 114-T, p. 24. The adjustment is premised upon the assumption that, had the Company not experienced extraordinarily high levels of held orders during the test year, services would have been installed and generating revenue for the Company.

USWC contests the adjustment. USWC witness Okamoto contends that the Company currently meets minimum service quality requirements. Additionally, he contends that a revenue reduction of \$0.5 million further depresses funding of new infrastructure deployment in Washington. Ex. 101-T, p. 7

The Commission rejects the adjustment proposed by Staff. The current status of record-keeping and reporting of held orders makes it difficult to accept with confidence the link between an average month's held order number and loss of specific revenue. In addition, Ms. Beaton does not offset asserted revenues with the costs associated with providing service.

B. Team and Merit Awards

Ms. Beaton also proposes disallowance of part of the incentive pay associated with the Company's Team and Merit Awards program. Specifically, she recommends disallowance of that portion of the program for Customer Service Measurement (CSM) amounting to a \$1.3 million reduction in test year salary expense as shown in Ex. 670-C, RSA-13. The adjustment is premised upon poor customer service related to deterioration in overall levels of service quality.

The Commission's treatment of the Company's Team and Merit Award program is discussed in specific detail in the revenue requirements section of this order.

C. Management Salary Increase

Staff witness Spinks proposes to disallow recovery of test year and pro forma management salary increases. Ex. 602-T, pp. 18-19. The adjustment as shown in Ex. 730-C, MLT-25, would reduce salary expense by \$7.6 million in recognition of the failure of Company management to provide an adequate level of service quality. Mr. Spinks contends that the Commission could provide an incentive to the Company to provide better levels of service by allowing it to seek increased rates to recover salary increases once it demonstrates that service has improved.

The Commission believes that the suggested adjustment is not sufficiently related to the problem it is asserted to address. We therefore will not make this adjustment, in favor of incentives aimed at the specific problem and designed to motivate the Company to address and improve service quality.

D. Equity Return Adjustment

Finally, Mr. Spinks recommends that the Commission adopt a return on equity at the low end of the range of reasonableness found appropriate by the Commission. He states that the Company, Commission Staff, and Public Counsel have testified to a range of return on equity which represents the bounds of reasonableness on the overall cost of common equity for the Company. Once the Commission establishes the appropriate equity return range of reasonableness, he urges that the Commission establish a return at the low point of the range in recognition of the service quality degradation plaguing the Company and its customers. Ex. 602-T, pp. 17-18.

USWC opposes any Commission action in response to the Company's service

quality problems. Mr. Okamoto contends that, while the Company's high service standards have slipped during its restructuring "to meet the reality and dynamics of a fully competitive environment," it continues to meet minimum standards. Therefore, no "performance penalties" in terms of a rate of return adjustment are appropriate, especially where competitors are not held to the same standards. Ex. 101-T, p. 15

The Commission has held, in other instances, that it may review service quality in setting a public service company's rate of return. The Commission in WUTC v. Alderton-McMillin Water System, Inc.,¹³ found that the level, scope, and on-going nature of the company's management and service quality problems argued for a return on equity less than would be appropriate for a company providing adequate service. The Oregon Public Utility Commissioner after noting complaints regarding substandard service, unreasonable delays in disposing of out-of-service reports, and other service related problems established a telephone company's rate of return in the lower ranges of the zone of reasonableness.¹⁴ Other state public utility commissions and courts have also held that service quality may be considered in setting a reasonable return on equity.¹⁵

The Commission will adopt the Staff recommendation with regard to the authorized return on equity, not as a penalty but as an incentive to improve customer service. The Commission expected Company management to meet its commitment to resolve its service quality problems, and refrained from instituting proceedings and levying fines as service quality continued to deteriorate. However, the Company has shown no willingness or ability to bring an end to its customer service problems, and our patience is at end. The rate case consideration of service quality in setting a return on equity at the lower end of the range of reasonableness is a well-established regulatory response to documented abuse of a Company's public service obligation.

Commission Staff suggests, and we agree, that the Company may petition to have its authorized equity return adjusted to midrange, and to have revenue requirement adjusted to reflect the amount of the adjustment in this order. The Company will be expected to demonstrate that its service quality in terms of held orders, in terms of missed or incomplete appointments, in terms of repair service in compliance with rule, and in terms of customer complaints to the Commission, all have returned to and remain stable at levels comparable with the Company's experience prior to 1991 and consistent with other local exchange companies within the State. The petition will be particularly persuasive if Commission Staff and Public Counsel join in it.

¹³ Third Supplemental Order, Docket No. UW-911041, August 31, 1992.

¹⁴ Re West Coast Teleph. Co., 27 PUR 3d (Oregon, 1958)

¹⁵ Re General Telephone Co. of Ohio, 68 PUR4th 212 (Ohio, 1985); Re Norfolk & Carolina Tel. & Tel., 18 PUR4th 592 (N. Carolina, 1977); Re South Cy. Gas Co., 53 PUR4th 525 (Vermont, 1983); Pet. of Young's Community TV Corp., 442 A 2d 1311 (Vt., 1982)

The determination of the capital structure and the equity return component are discussed in specific detail below. This adjustment decreases revenue requirement by \$6.5 million.

PART FOUR:

RESULTS OF OPERATION

The parties propose, and the Commission accepts, that the period beginning November 1, 1993 and ending October 31, 1994 be used as a test period for examining the Company's operations. It is the latest period for which information has been available throughout the preparation for and processing of this proceeding. It has been used by all parties as the basis for their analyses of the Company's performance and condition.

In accepting this test period, the Commission does not find that the relationships that existed during the period are necessarily representative of the future. The Commission considers in this order a number of adjustments that parties suggest to make the test period more representative of future relationships. The Commission finds that the 12 months ending October 31, 1994, is the appropriate test period for examination of the Company's operations for purposes of this proceeding.

The Company starts with a portrayal of its operations and its property during the test year in Exhibit 198. The Commission finds that the Exhibit 198 sufficiently reflects the Company's actual property and operations during the test year to be regarded as the appropriate starting point for regulatory analysis. It should therefore be accepted for purposes of this Order.

Numerous adjustments are proposed, and matters presented for analysis. We group those¹⁶ in the areas of adjustments to revenues, to operating expenses, those regarding affiliated transactions, taxes; rate base, and determination of rate of return. In each discussion we identify our decision's effect on rate base and operating results. At the conclusion of this Part of the order, we display the results in tabular form to identify the major components of ratemaking analysis: revenue requirement equals the authorized rate of return times rate base, plus operating expense.

¹⁶ We follow the outline of issues prepared by the parties. The Commission commends the parties, especially the Company, Public Counsel, and Commission Staff, for producing the agreed outline. The outline has assisted the parties in making effective presentations and assisted the Commission in the thorough and careful consideration of parties' presentations.

I. Legal Standards

The ultimate determination to be made by the Commission in this matter regarding the Company's rates and charges is whether the rates and charges proposed in revised tariffs are fair, just, reasonable, and sufficient, pursuant to RCW 80.28.020. These questions are resolved by establishing the fair value of respondent's property in-service for intrastate service in the State of Washington, determining the Washington intrastate adjusted results of operations during the test year, determining the proper rate of return permitted respondent on that property, and then ascertaining the appropriate spread of rates charged various customers to recover that return.

The purpose of a rate proceeding is to develop evidence from which the Commission may determine the following:

1. The appropriate test period, which is defined here as the most recent 12-month period for which income statements and balance sheets are available. The test period is used for investigation of the Company's operations for the purposes of this proceeding;
2. The Company's results of operations for the appropriate test period, adjusted for unusual events during the test period, and for known and measurable events;
3. The appropriate rate base, which is derived from the balance sheets of the test period. The rate base represents the net book value of assets provided by investors' funds which are used and useful in providing utility service to the public;
4. The appropriate rate of return the Company is authorized to earn on the rate base established by the Commission;
5. Any existing revenue excess or deficiency; and
6. The allocation of the rate increase or decrease, if any, fairly and equitably among the Company's ratepayers.

RCW 80.04.130 places the burden of proving that a proposed increase is just and reasonable on the public service company proposing such an increase.

II. Revenues

The Commission's first task in examining results of operation is to determine the Company's adjusted revenues for the test period.

USWC's exhibit 198 reflects its actual revenues for the test period, separated for Washington intrastate jurisdictional operations. Three adjustments are contested: one to give effect to a Commission-ordered rate reduction after the test year; one to impute revenues of the Company's prior Yellow Page operations; and one to reflect service quality concerns. Other decisions affect revenues and will be discussed in appropriate segments of the Order.

A. Revenue Levels RSA-3, C-1¹⁷

The Company proposes adjustment RSA-3 to reflect a rate reduction that the Commission ordered in 1994, during the test period. Commission Staff witness Twitchell accepts the Company's adjustment, and makes changes only to give effect to taxes and fees on the pro forma revenues. The Company accepts Mr. Twitchell's revisions.

Public Counsel witness, Mr. Brosch, contends that adjustment RSA-3 to reduce local revenues is an inappropriate pro forma adjustment because it does not consider offsetting factors. He contends that increasing revenues more than compensate for the decreased rates. Mr. Brosch proposes adjustment C-1, which would increase local exchange revenues to an annualized level based on the fourth quarter of 1994 rather than the adjusted test year figure.

The Company responds, through Ms. Wright, that Public Counsel's adjustment is inappropriate. She states that the Company's proposed adjustments to revenue are consistent with prior Commission orders and that his adjustment is one sided, pointing out that the adjustment does not annualize toll revenue, which she contends has shown a decline.

Mr. Brosch finds no reason to further adjust toll and access revenues. He indicates that the primary toll carrier and sale of rural exchanges adjustments are appropriate and that they properly adjust the toll access revenues. He points out also that the Company's rate base is declining and that use of an average figure -- which he does not propose to change -- operates to the Company's advantage.

The Commission finds that Mr. Brosch is most credible in his analysis and that the revenue portrayal with his adjustment most accurately reflects the Company's ongoing operations. The Commission agrees with Mr. Brosch that the use of the test year has to be balanced. The Commission cannot take one event, the rate reduction, out of the context of what is happening in the entire operation. That is the purpose of a general rate proceeding. It is our primary duty to look at relationships among revenues, costs, and rate base as they relate to the future. Ms. Wright's presentation does not reflect the Company's shrinking rate base. To the extent that toll revenues are dropping, the Company did not submit an adjustment to reflect that, and the falling rate base will tend to ameliorate it. The Commission reasons that, therefore, Public Counsel's position should be adopted and both adjustments accepted.

¹⁷ The numbers following each heading refer to the adjustments that are discussed in the following section. The adjustments are shown both on the appended comparison table and on the Commission's table of results of operation and rate base following the discussion of rate base.

B. Yellow Page Imputation, SA-1 and C-3

Before 1984, Pacific Northwest Bell, the predecessor in Washington State of US WEST Communications, Inc., published its own telephone directory, including Yellow Pages.¹⁸ Ex. 390-T, p.16. The publishing revenues and expenses were a part of the Company's results of operation for regulatory purposes and constituted a regulatory asset of the Company. Effective January 1, 1984, directory publishing was placed in Landmark Publishing Company. The publisher is now US WEST Direct (USWD), a division of US WEST Marketing Resources Group, Inc. (MRG). Between 1984 and 1988, the affiliated directory publisher paid annual publishing fees to USWC, ranging in amount from \$14.9 million to \$40.5 million. The payments ceased after 1988, according to USWC, "... because USWC recognized that there was no operational or business need for a cash payment to flow between the two US WEST companies." There is no indication that PNB or USWC received compensation other than the publishing fee for the transfer of the directory business or that it received compensation for the termination of the publishing fee. USWD is the exclusive publisher of directories for USWC, which provides billing and collection services exclusively to it.¹⁹

In the Second Supplemental Order, Cause No. U-86-156, the Commission treated the Directory as a regulatory asset and determined that the public interest requires the full reasonable value of directory publishing be available to PNB for ratemaking purposes. It found that the then-current publishing fee was not determined in an arms-length transaction with each party seeking to maximize return, but deferred adjusting the value until a later time.²⁰

As a condition to the merger of PNB into USWC, all of the parties including USWC agreed in a signed stipulation, presented to the Commission and approved, that if the merger were approved, Yellow Page revenues would be considered as though the merger had not taken place.²¹ The order provided that the Commission could modify the arrangement by a future

¹⁸ For convenience, because USWC is the successor to PNB and USWD and MRG the successor to Landmark, references using the current company's name shall be deemed to include the predecessor entity if required in context because of the timing of events, and references to MRG or USWD are interchangeable unless required by the context.

¹⁹ USWD also publishes one directory for customers in the Washington State territory of one other Company.

²⁰ The Company argues that this order did not become final for procedural reasons involving the settlement of litigation. Whether or not we treat the order as "precedential," we believe that it expresses a sound analysis and we accept and adopt the analysis as having continuing validity.

²¹ The settlement agreement reads in part as follows:

6. Directory. A. USWC agrees that the fact of the merger has no legal impact whatsoever on the issue of imputation of revenues to USWC for directory advertising. * * *

order. The Alternative Form of Regulation (AFOR) agreement between the Commission and the Company in 1990 contained an implicit directory imputation calculation.

US WEST opposes the revenue imputation. The Company did provide a calculation consistent with the order in U-89-2698-F and U-89-3245-P. The Company calculation yielded an adjustment which would increase operating income by \$49.2 million. Staff witness, Ms. Strain, accepts the method used by the Company but adjusts the inputs to Staff's level for rate of return and net-to-gross multiplier. Her results would increase net operating income by \$50.6 million.

Dr. Selwyn for Commission Staff recommends that yellow page revenues be allocated at \$4.27 per residential line per month to lower residential rates. He also argues that, because Yellow Page imputations are intended to subsidize residential service, not USWC's competitive advantage, and because alternative local operating companies (ALECs) may be able to take the operating revenues such as toll, but will not be able to dent USWC control of directory revenues, the Yellow Page subsidy should be portable with the residential customer. He does not explain how this portability would work.

Public counsel's witness, Mr. Brosch, proposes a revenue imputation approximately \$3.5 million larger at the NOI level than Commission Staff's. Public Counsel/TRACER calculate the appropriate contribution at \$4.76 per residential line, per month.

Ms. Koehler-Christensen presented USWC rebuttal. Her testimony identifies the level of contribution in current rates as \$2.29 per line per month.

We are not convinced that Mr. Brosch's method is more accurate, but believe that his approach to the calculation may have merit for the future. The Commission does believe that revenues earned in the State of Washington should be allocated to the State of Washington. The Commission will reject Mr. Brosch's calculation in this proceeding, however, because of concerns that amounts may be inaccurate.

The Commission finds that the Commission Staff method of calculating the adjustment is proper. It is simpler and is more directly tied to the Company's information. Because the imputation depends on rate of return, we have recalculated it using the accepted rate of return. The resulting dollar value of the adjustment is \$50,934,378 at the net operating income (NOI) level.

The Company repeats many arguments in its brief that it raised, and the Commission rejected, at the outset of the hearing when the Commission rejected the Company's motions to remove yellow page advertising revenues from consideration as a matter of law. The Company also raises some new arguments. The Company cites no Commission or court decision in any USWC jurisdiction or in any other jurisdiction that specifically accepts any argument that USWC presents, but notes on reply that a Wyoming statute now forbids imputation.

The Company's arguments are as follows:

1. The Company argues that the advertising revenues are not earned by USWC, which has transferred the directory publication to an affiliated company. These are nonregulated revenues, it argues, and not only may the Commission not consider them, it exceeds its statutory authority and commits a dire constitutional violation by attempting to do so. It argues that the Commission does not seek to seize the revenues of other nonaffiliated publishers, and therefore, taking the USWD revenues is improper and discriminatory. USWC has no more access to its affiliate's revenues, USWC argues, than to revenues of nonaffiliated publishers. It stresses that the revenues are not for telecommunications services, which the Commission does have the power to regulate.

The Commission rejects this argument. There is no seizure of revenues, which are at all times entirely under the control of the affiliate and are never used or directed by the Commission. Instead, for regulatory purposes in calculating performance, the Commission imputes the "excess" revenues to USWC results of operation. The Company agreed that the merger would have no effect on imputation. The Commission finds the directory publishing business to be a regulatory asset. Commissions have historically been authorized to impute revenues from interrelated operations that have been transferred to affiliates, to prevent utilities from taking profitable aspects and leaving captive utility customers with expenses of the operation but with reduced offsetting revenues from related services.

2. The company argues that, under the decision in POWER v. WUTC, 104 Wn.2d 798, 711 P.2d 319 (1985), the allowable ratemaking formula is that the revenue requirement equals operating expenses plus the product of the rate of return times the rate base. Because affiliates' incomes are not any of those elements, says the Company, they may not be considered in ratemaking.

The Commission rejects this argument. The POWER decision does not forbid proper and lawful ratemaking adjustments in deriving the levels of expense, rate base, or rate of return. Neither does it forbid reasonable and lawful adjustments in calculating the Company's test period revenues -- a sum that is necessary in order to determine either the excess revenues or the revenue deficiency that must be met through rates to allow the Company to achieve its revenue requirement.

3. USWC argues that a regulated utility has the right to conduct a nonregulated business. The Company cites several Supreme Court cases from the early years of the twentieth century in support of its argument, and contends that the proposal to impute yellow page revenues would violate that right.

The Commission does not disagree with the proposition that a regulated utility has the right to conduct a nonregulated business. The proposed imputation does not interfere with USWC's right to conduct any business it wants, nor does it interfere with its affiliate's right to conduct any business. The USWC citations are irrelevant to the circumstances.

4. The Company argues that Wash. Const. Art. XII, Sec. 19 declares that telephone companies are common carriers and subject to regulation. It contends that the proposal regulates advertising, and notes that advertising is not included as a business subject to regulation under the Constitution.

The Commission rejects this argument. The Commission exercises no jurisdiction over advertising, which is not regulated in any way by this proposal. Only the utility is regulated or affected, pursuant to statutory and Constitutional authority.

5. The Company argues that RCW 80.04.270 forbids the Commission from considering revenues from the sale of merchandise as part of a regulated company's operating revenues. Although US WEST argues that merchandise is not defined in the statute, it argues that printed advertisements are clearly merchandise and within the terms of the statute.

The Commission rejects this argument. Merchandise includes all goods which merchants usually buy and sell.²² US WEST Direct is not a printing job shop, and the advertiser is not purchasing any goods of any kind. The Commission finds that the advertiser is purchasing the service of having advertisements printed and distributed to every telephone subscriber. The advertiser has no property right in any printing, printed advertisements, or other physical property as a result of the advertisement. Thus there is no sale of merchandise, and the statute is inapplicable.

6. The Company argues that the Commission's general power to regulate in the public interest or to approve affiliate contracts does not authorize imputation.

The Commission rejects this argument. The issue here is not contract approval; it is accounting for income and expenses and assigning responsibility for the reasonable operation of the utility and the Company's dealing with a regulatory asset. The Commission clearly has authority to do that under its power to regulate in the public interest.

7. USWC argues that the company has not acquiesced or waived its rights. There was no rate case, prosecuted to conclusion, in which imputation was an issue. The order in U-86-156 was appealed but dismissed upon the agreement of both parties that the orders were not final. No settlement temporarily acquiescing in imputation can be used as a waiver.

Whether or not the Company waived its rights, it has accepted imputation as an element of the AFOR. The dismissal of the order in U-86-156 does not diminish the force of the Commission's logic and the correctness of its analysis.

²² Black's Law Dictionary, 5th Ed. (1979), at 890

8. USWC argues that under the Telecom Act, universal service may only be subsidized on an equitable and nondiscriminatory basis, and imputing income to USWC is improper because there is no evidence subsidies are needed by all customers including those who may be millionaires.

The Commission rejects this argument. The proposal is not a universal service subsidy. It is a ratemaking adjustment. Its purpose is to reflect funds that would be available to the Company, but for Company action. In any event, the Commission finds in this Order that existing rates for local exchange service do cover incremental costs of providing that service, which thus needs no "subsidy", and the Commission does not attribute or " earmark" the directory imputation directly to any class of customers. Therefore the subsidy argument is inapposite.

9. USWC argues that the Commission cannot explore whether USWC acted reasonably in transferring the directory because management decisions belong to the Company, not the regulator. It cites Missouri v. Southwestern Bell, 262 US 276 (1923) for the proposition that regulated companies retain their management prerogatives.

The Commission rejects this argument. It is not interfering with management prerogatives in any way. The Commission did not prevent company management from doing anything. The Commission is making a ratemaking adjustment for excessive earnings that the Company earned or could have earned or retained the right to earn, based on agreement and historical precedent.

10. The Company argues that nothing in U-86-156 or U-89-3524-AT decide this issue.

i) The Company contends that the orders do not address today's policy issues: cross subsidization and harm to competition. The Commission rejects the argument. The earlier orders did not anticipate and do not address some current circumstances or policy issues. That does not render them invalid. The Commission has the power to modify earlier orders when it believes doing so is appropriate, under pertinent statutes.

ii) The Company argues that neither docket was a rate case and no finding in those cases forecloses USWC from litigating the issue of subsidizing competitive and potentially competitive telecommunications services with Directory income; the agreement is obsolete. The Commission rejects the argument. That neither prior proceeding was a rate case appears to be irrelevant. The Commission specifically finds that the imputed revenues do not provide a subsidy to any customers or class of customers. The agreement is not shown to be obsolete.

iii) The Third Supplemental Order in U-89-3524 did not actually affect rates and thus was not ripe for appeal on this issue. The Commission rejects the argument. The Commission disagrees that the order was not ripe for appeal; whether the order actually affected

rates would not determine whether it was appealable.²³

iv) MRG gets listings on the same basis as other companies. The Commission rejects the argument. MRG's access to listings and preferential or lack of preferential status regarding access to the listings are not the basis for this decision. The Commission is not regulating MRG but is attributing revenues based on several grounds: the Company's foregoing its ability to maintain a historically integrated operation benefiting ratepayers, its failure to secure benefit for losing the regulatory asset, and its failure to secure compensation for the benefits that MRG currently enjoys. MRG's current market advantage stems from its exclusive arrangements with USWC and not from its nonexclusive ability to secure listings.

v) USWC argues that it did not waive any rights by conceding imputation until further order because an agency does not have the power to define the scope of its own authority (*In re Consolidated Cases*, 123 Wn.2d 530 (1994)). The Commission rejects the argument. USWC had every opportunity to litigate and every right to appeal the Commission's order in U-89-3524-AT. It did not, and it now concedes that the order provided that directory revenues will be imputed unless and until altered by subsequent order

vi) USWC argues that the agency gets its power from the legislature, "not from extracting agreements from regulated companies on pain of denial of that to which they are entitled by law." [Emphasis added; USWC Revenue Requirements brief, p. 9]. The Commission rejects the argument. There is no evidence that the Commission or Commission Staff or anyone else extorted something in a way that was improper. On the contrary, the agreement appears to have been entirely voluntary.²⁴

²³ RCW 34.05.530 reads as follows: Standing. A person has standing to obtain judicial review of agency action if that person is aggrieved or adversely affected by the agency action. A person is aggrieved or adversely affected within the meaning of this section only when all three of the following conditions are present:

- (1) The agency action has prejudiced or is likely to prejudice that person;
- (2) That person's asserted interests are among those that the agency was required to consider when it engaged in the agency action challenged; and
- (3) A judgment in favor of that person would substantially eliminate or redress the prejudice to that person caused or likely to be caused by the agency action. (1988 c 288 § 506).

²⁴ The Commission addresses all of the Company's arguments presented as to yellow page revenue imputation, even though many of the arguments are repetitious of matters previously argued and decided, and others are so patently silly that they insult the Commission's intelligence. USWC's argument that in effect alleges extortion, however, is shocking and outrageous. USWC presented not one iota of evidence supporting this claim. The Company's record of litigation before this Commission and in the courts demonstrates clearly that it knows how to secure redress speedily and successfully if it believes that its interests are adversely affected. If extortion occurred, unbeknownst to the Commission, we call on the Company to bring forward that

11. USWC contends that the Staff is wrong, and the Tunney Act proceedings²⁵ didn't set the policy that directory earnings should defray local service. The Tunney Act case was only to determine whether the consent decree was consistent with the public interest under antitrust principles. The decision only contemplated that directory revenues would offset local exchange costs, and did not authorize or require that to happen. The Tunney Act decision ruled improper a provision in the Modification of Final Judgment (MFJ) that Regional Bell Operating Company (RBOCs) be excluded from directory publication. Other than that, the decision was dictum.

The Commission rejects this argument. While the decision clearly did not specifically order imputation, there is nothing in the decision that would support USWC's position or indicate any judicial impediment to imputation. On the other hand, imputation is a logical and appropriate consequence of the decision.

12. The Company contends that Staff's suggestion that the Company be required to pay competitors the amount of the imputation is beyond the Commission's statutory power and illustrates the need to end imputation.

The Commission does not accept the Staff suggestion. It would appear to raise substantial issues that are not necessary to decide and that the Commission does not choose to address in this proceeding.

13. The Company argues that Staff and Public Counsel/TRACER are in error in assuming that the future will forever replicate the past, and that the state has the power to seize profits of non-utility affiliates.

The Commission rejects this argument. The Company mischaracterizes the Commission Staff and Public Counsel/TRACER positions and the result of the proposed action. Neither never-ending imputation nor seizure of income is contemplated or attempted here. The profits of non-utility affiliates are not touched in any way. They are merely imputed to USWC, as is permitted by law.

14. USWC contends that MRG does not have a monopoly and its return isn't inconsistent with competitive returns in the advertising business. It argues that there is no evidence that USWC's association with USWD leads people to advertise in the directory. The directory does not use public right of way or eminent domain power of the utility. Imputation conflicts with RCW 80.36.300, encouraging diversity of supply.

evidence so investigation and possible prosecution can occur. Without that evidence this accusation has no place in a professional presentation.

²⁵ United States v. Western Electric Co., 552 F.Supp. 131, 148 (D.D.C. 1982), Aff'd. sub nom Maryland v. United States, 460 U.S. 1001 (1983)

The Commission rejects this argument. MRG's possession or lack of a monopoly in the directory market does not appear critical to the imputation decision. The Commission finds that USWC's association with MRG is a benefit to the directory, based on the testimony of Staff and Public Counsel/TRACER witnesses and its mention as a benefit by more than one "public" witness. No one is contending that the directory uses public right-of-way or powers of eminent domain. No party is contending that the law of right of way or eminent domain support imputation of directory revenues. Imputation has nothing whatsoever to do with diversity of supply as it imposes no restrictions whatsoever upon diversity.

15. USWC contends that the proposal violates USWC's constitutional rights. that Staff's proposal to pay customers of other carriers is confiscatory and that treating USWC differently and more harshly than other carriers is discriminatory.

The Commission rejects USWC's arguments. Staff's proposal to fund customers of other companies is not accepted. USWC is treated fairly, based upon USWC's unique circumstances. There is no impermissible discrimination. See, Oregon P.U.C. v. Pacific Northwest Bell Telephone Co., Docket UI-54, Order 88-488 (May, 1988).

16. The Company contends that imputation contradicts the general purpose of regulation, which is to simulate the result of an unregulated market. An unregulated business would never subsidize a less profitable line with a more profitable line.

The Commission rejects this argument. The Company cites only one of the underlying principles of regulation. It is also a recognized principle that the Commission must regulate in the public interest.²⁶ Utilities, operating as natural monopolies, may have the power to operate for their own corporate interests, adversely to the interests of ratepayers. The Commission is charged with protecting the ratepaying public. One of the Commission's functions has been to protect customers of noncompetitive services from utilities' self-dealing. Utilities may have the power to subdivide the integrated utility operations and divest for their own organizational goals or profit objectives any discrete, divisible, and potentially profitable aspect of that operation. Imputation is entirely consistent with the purpose of regulation as a tool to minimize adverse effects on such division and divestiture when those circumstances occur.

²⁶ RCW 80.01.030 reads in part as follows: The utilities and transportation commission shall:

* * * *

(3) Regulate in the public interest, as provided by the public service laws, the rates, services, facilities, and practices of all persons engaging within this state in the business of supplying any utility service or commodity to the public for compensation, and related activities; including, but not limited to, telecommunications companies